LAO PEOPLE'S DEMOCRATIC REPUBLIC

Gradual economic recovery continued in 2022, benefiting from border reopening and improved mobility. Recovery in services will likely continue to drive growth this year and next. Currency depreciation in 2022 will keep inflation high in 2023, particularly for food and fuel, dampening household purchasing power. Rising wages in neighboring countries are incentivizing workers to migrate out of the Lao People's Democratic Republic (Lao PDR), which poses challenges for economic recovery.

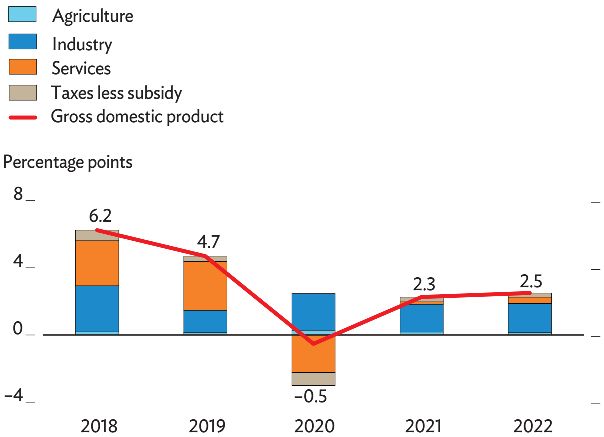
Economic Performance

The economy grew by 2.5% in 2022 with support from border reopening. As mobility improved across Southeast Asia, regional tourism stimulated spending on domestic services in hospitality, trade, and transport. International tourist arrivals climbed from zero in 2021 to 1.3 million in 2022, and domestic tourist numbers increased by 76% to 1.4 million. However, high inflation, fuel shortages in June, and rising input costs caused by insufficient foreign exchange for fuel imports dampened domestic consumption and activity in construction, manufacturing, and agriculture (Figure 2.25.1).

Industry was supported by rising electricity generation for export and construction on important investment projects. Sufficient rainfall allowed many hydropower plants to optimize their production capacity. Electricity generation in 2022 increased by 13% to 50,975 million kilowatts, most of which was exported to neighboring countries (Figure 2.25.2). Major ongoing construction projects include the rehabilitation of National Road No. 13, Bokeo International Airport, and a fifth bridge across the Mekong River. Higher inputs cost, including for fuel and labor, delayed progress on some projects.

Figure 2.25.1 Supply-Side Contributions to Growth

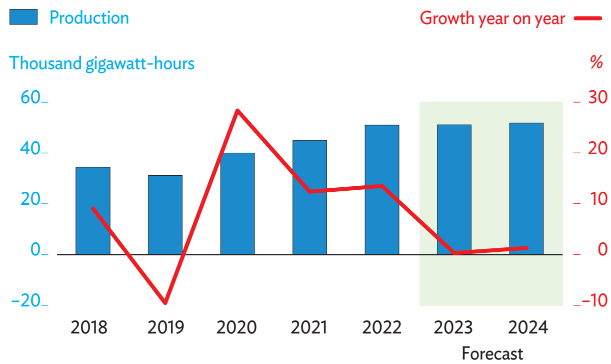
Services gradually recovered from the pandemic.



Sources: Lao Statistics Bureau; Asian Development Bank estimates.

Figure 2.25.2 Electricity Generation

Electricity generation has increased, most of it for export.



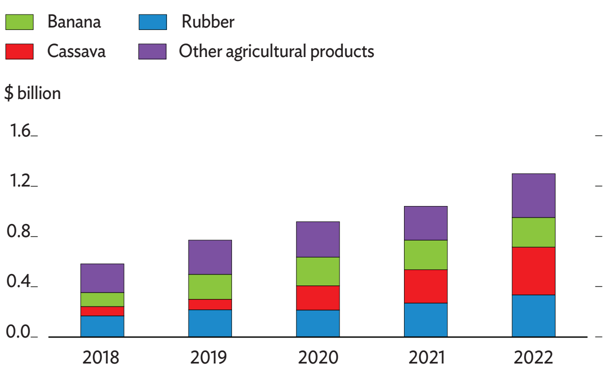
Source: Ministry of Energy and Mines.

This chapter was written by Emma Allen and Soulinthone Leuangkhamsing of the Lao Resident Mission, ADB, Vientiane.

Agriculture was hampered by fuel shortages and the rising cost of inputs. Favorable weather and demand for agricultural exports partly offset rising prices for fuel, fertilizer, and animal feed that held down production for and sales in local markets. Agricultural exports rose from $871 million in 2021 to $1.3 billion in 2022. Cassava output increased by 31% to 4.8 million tons, sugarcane by 32%, and coffee by 6.0%, while rice production increased moderately by 3.3% to 3.8 million tons (Figure 2.25.3). However, high inflation, particularly for food, rendered one in seven households food insecure, and over half meeting essential needs by sacrificing health or education spending, for example, or drawing down savings.

Figure 2.25.3 Agriculture Exports by Major Component

Favorable weather benefited agriculture exports.

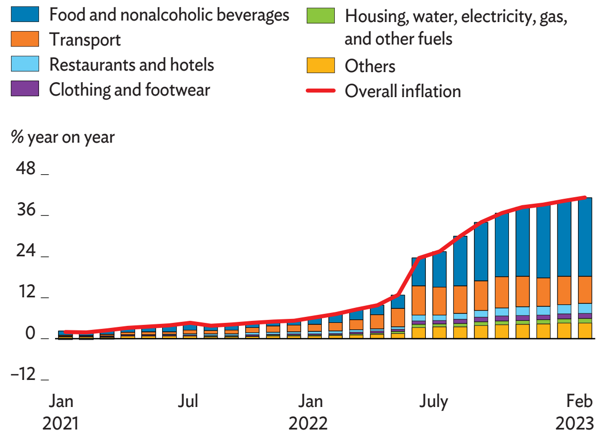


Source: Ministry of Industry and Commerce.

High inflation dragged on recovery. Average inflation jumped from 3.8% in 2021 to 23.0% in 2022 (Figure 2.25.4). Rising oil prices and a weak Lao kip pushed the inflation rate to 39.6% in December 2022, a record high since the Asian Financial Crisis of 1997–1998. Average retail petroleum prices increased by 82.2% in 2022, while the kip depreciated against the US dollar by 53.6% on the official market (Figure 2.25.5). The shortage of foreign currency to pay for fuel imports in June 2022 caused the kip to depreciate, with price differentials on imports passed through to farmers and consumers. Rising input cost, particularly for fertilizer, fuel, and animal feed, drove up prices for staples such as rice and meat, which together are weighted at 46% of the consumer price index. To tackle inflation and stabilize the exchange rate, the Bank of the Lao PDR, the central bank, raised its policy rate from 3.1% to 6.5% and, to boost liquidity in commercial banks, suspended the business licenses of exchange bureaus operating in the parallel market. It also provided foreign exchange through commercial banks for imports of critical goods.

Figure 2.25.4 Monthly Inflation

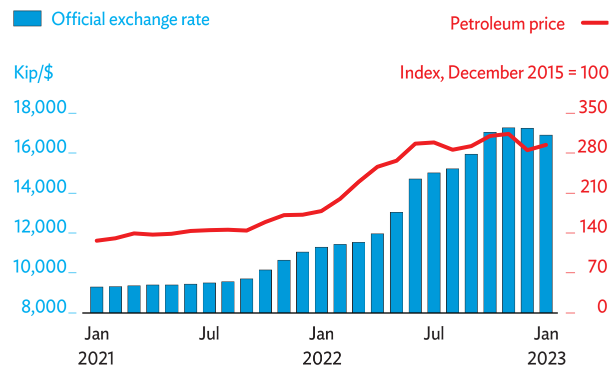
Inflation accelerated in 2022, particularly for food and fuel.



Source: Lao Statistics Bureau.

Figure 2.25.5 Exchange Rate and Petroleum Price

Rising oil prices and a weak Lao kip contributed to rising inflation.

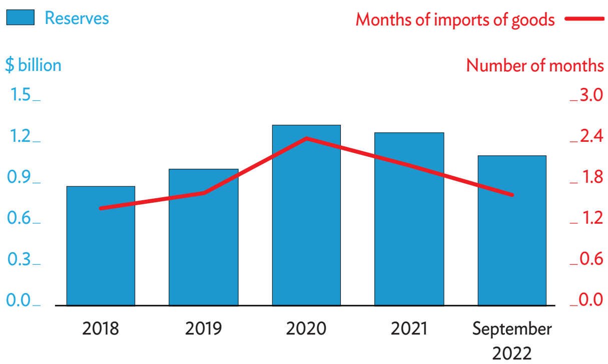


Sources: Lao Statistics Bureau; Bank of the Lao PDR.

The current account deficit narrowed to the equivalent of 4.7% of GDP as growth in exports outpaced imports. Trade recorded a surplus of $405 million in 2022, most of it from exports of electricity and agricultural commodities. Electricity exports rose by 9% to $2.3 billion, while agricultural exports reached $1.3 billion. Import growth was subdued by high global oil prices, the weaker kip, and meager foreign exchange reserves. Gross official reserves were $1.1 billion at the end of September 2022, or cover for only 1.6 months of goods imports, down from 2.0 months just 3 months earlier in June (Figure 2.25.6).

Figure 2.25.6 Reserves and Imports

Foreign currency reserves cover for imports has dropped.

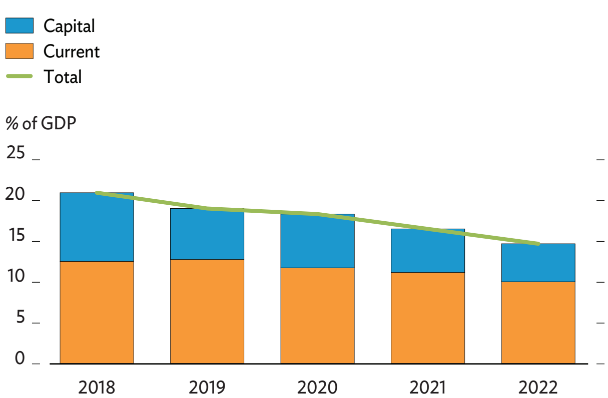


Sources: Bank of the Lao PDR; Asian Development Bank estimates.

The fiscal deficit widened from the equivalent of 1.3% of GDP in 2021 to 1.6% in 2022. The government's balance sheet was hit by exchange rate effects that drove up interest payments and tax relief granted to contain retail fuel prices. Expenditure reached KN33.2 trillion, or 95.8% of planned expenditure as the government continued fiscal consolidation by holding back spending on capital investment (Figure 2.25.7). Expenditure arrears to the private sector continued to be a problem, signaling an urgent need for progress to resolve public finance issues pertaining to procurement and the management of contracts and cash flow. Tax revenue collection reached KN24.4 trillion, or 95.5% of the target, despite massive tax exemptions for fuel imports and a reduction to the value-added tax to mitigate the rising cost of living. These two measures cost the government budget an amount equal to 0.9% of GDP.

Figure 2.25.7 Government Expenditure

Current expenditure rose relative to the total as the government reined in capital spending.

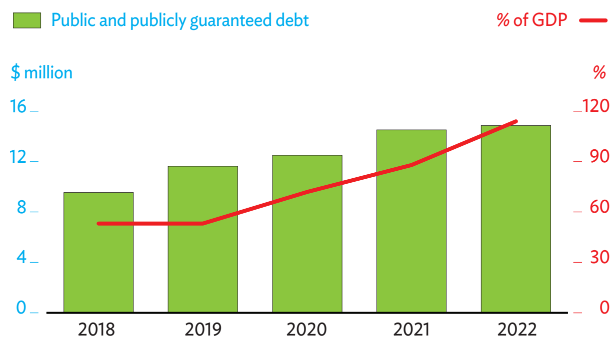


GDP = gross domestic product.
Sources: Ministry of Finance; Asian Development Bank estimates.

Public and publicly guaranteed debt surpassed 100% of GDP in 2022, driven by kip depreciation. Sharp kip depreciation in 2022 saw the ratio of public debt to GDP rise (Figure 2.25.8). However, the stock of external and domestic public debt remained stable—external at $12.4 billion, equal to 94% of GDP, and domestic at KN29.4 trillion, or 16.0%—much of it incurred at low interest rates. Nonetheless, public debt will continue to be elevated for a protracted period, with market confidence vulnerable to exchange rate fluctuation. External public debt servicing requirements will average $1.2 billion annually over the next 5 years, half of which is owed to the People's Republic of China (PRC). However, from 2020 to 2022, reported debt service payments to the PRC have been less than the amounts scheduled.

Figure 2.25.8 Public Debt

Kip devaluation in 2022 saw the ratio of public debt to GDP rise.



GDP = gross domestic product.
Sources: Ministry of Finance; Asian Development Bank estimates.

Economic Prospects

Real GDP growth is forecast to expand moderately by 4.0% this year and next (Table 2.25.1). The reopening of the PRC border and increased operation of the Lao–PRC railway will support recovery. New and ongoing investment from private sector infrastructure projects, including industrial parks and renewable energy, will support industrial performance. However, inflation will remain high along with interest rates, depressing consumption and domestic investment. Limited fiscal space will continue to drag on recovery.

Tourism and logistics will boost recovery in services. With upgrades to major connectivity infrastructure complete and borders now reopened, international

Table 2.25.1 Selected Economic Indicators, %

Growth is forecast to pick up while inflation remains elevated.

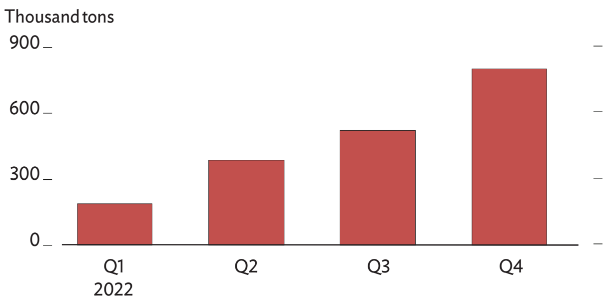
	2021	2022	2023	2024
GDP growth	2.3	2.5	4.0	4.0
Inflation	3.8	23.0	16.0	5.0

GDP = gross domestic product.
Sources: Lao Statistics Bureau; Asian Development Bank estimates.

tourist arrivals are projected to double from 1.3 million in 2022 to 2.6 million in 2023. Transit freight is expected to continue its steady expansion, with 1.3 million passengers and 1.9 million tons of cargo transported through the Lao PDR–PRC rail link in 2022 (Figure 2.25.9). Tourism will enjoy additional support with the Lao PDR as the 2024 chair of the Association of Southeast Asian Nations (ASEAN).

Figure 2.25.9 Cargo Transported through the Lao PDR–PRC Rail

Freight traffic has grown steadily.



Lao PDR = Lao People's Democratic Republic, PRC = People's Republic of China, Q = quarter.
Sources: Laos-China Railway Company; Asian Development Bank estimates.

Investment in renewable energy will drive moderate growth in industry. Four new hydropower plants with combined capacity of 400 megawatts will be commissioned in 2023. Construction of the 600-megawatt Monsoon Wind Power Project is expected to commence in 2023 and be completed by 2025. With a financing package of $692.55 million, the project will install 133 wind turbines in Sekong and Attapeu provinces in the southern region of the country, making it the largest wind farm in Southeast Asia and the first-ever cross border wind power project in Asia. New and ongoing infrastructure development projects include dry ports and industrial park development along the Lao–PRC rail link.

Agriculture expansion is to be gradual this year and next. The government has introduced low interest loans for farmers and processing factories for agricultural produce to promote commercialization for export. Agricultural commodities including cassava, banana, sweet corn, and livestock have been granted higher PRC import quotas under a bilateral trade agreement. The challenge now is to raise production to realize trade potential.

Inflation pressure will remain high in 2023. Average consumer inflation is projected to decline from 23.0% in 2022 to 16.0% in 2023 and further to 5.0% in 2024. Prices are expected to climb in 2023 as businesses pass on costs from imported goods and wage increases. Adjustments are also planned for electricity tariffs. Measures to support foreign exchange stabilization and monetary tightening will tamp down consumer demand and domestic-focused enterprises. As such, the balance sheets of households and businesses are expected to remain weak.

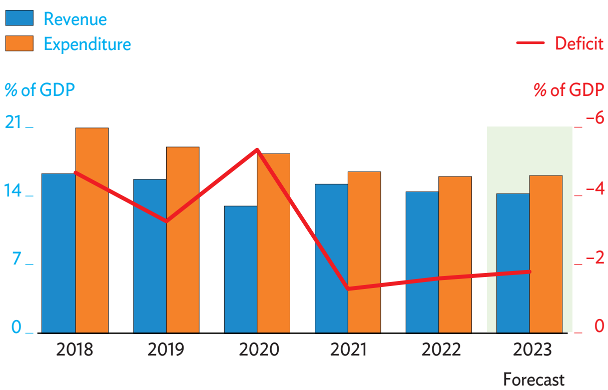
The current account deficit is expected to stabilize in 2023. The weaker kip will subdue imports of consumer products and slow spending on imported vehicles and household electronic goods. Import demand will be offset by continued strong export performance in electricity, minerals, and agricultural products. In 2024, the current account deficit is expected to widen on imports of capital goods for infrastructure projects.

Fiscal consolidation will continue. The government is targeting a fiscal deficit equal to 1.8% of GDP in 2023, to be achieved through restraint on capital spending (Figure 2.25.10). It also plans this year to revise the law on investment promotion to improve policy coordination concerning tax exemptions, and it is considering restoring the value-added tax, from 7% since 2021 back to 10%. In 2024, the government plans to upgrade the regulatory environment for public–private partnership by tabling a new law in the National Assembly.

Low foreign exchange reserves and high public debt are key risks to the outlook. The public debt stock remains high, as are official debt service payments coming due, with little official information forthcoming on debt relief from bilateral creditors. The speed of progress on domestic reform, including reform to improve the business environment and strengthen the financial sector, remain critical issues. The primary external risks

Figure 2.25.10 Fiscal Indicators

The government seeks to contain the fiscal deficit this year.



GDP = gross domestic product.
Sources: Ministry of Finance; Asian Development Bank estimates.

to the outlook are disappointing recovery in the advanced economies and the PRC, and commodity and food prices climbing higher than expected.

Policy Challenge—Managing the Emigration of Workers

Incentives to migrate for higher wages erode potential benefits to the Lao PDR from its young population. With almost two-thirds of its population currently of working age, the Lao PDR should be reaping the benefits of a demographic dividend—an acceleration of economic growth enabled by favorable demographics. A young workforce means that more people have potential to be productive and contribute to growth. However, comparatively low wages at home mean that many workers opt to work in neighboring countries in the Greater Mekong Subregion (GMS), where they can earn more. This creates challenges, including a shortage of skilled labor for local industry and loss of productive human capital—a brain drain—that, if sustained, could dampen the country's prospects for economic growth and industrial diversification.

Recent macroeconomic instability has eroded purchasing power. High inflation and kip devaluation in 2022 have curtailed purchasing power and imposed real income losses on workers in the Lao PDR, coincidentally lowering wages at home when compared with neighboring countries. In addition, scarring effects on the labor market from the pandemic have raised rates of unemployment and labor underutilization. As a result, workers are incentivized to explore options further afield in the GMS. With proximity and language similarity, Thailand is the most popular destination.

To compensate for rising living costs, policy makers increased the statutory minimum wage. In response to concerns about the increasing cost of living, the Lao PDR authorities raised the monthly minimum wage to $77. To further bolster purchasing power, they temporarily reduced the value-added tax and suspended the excise tax on fuel. Finally, the availability of foreign exchange for critical imports was increased to stabilize the exchange rate.

In parallel, Thailand increased the minimum wage across its provinces. The Thai authorities adjusted the minimum wage upward in 2022, putting the lowest monthly income at $235. While living costs are higher in Thailand, these costs are offset by salaries three times higher than are offered within the Lao PDR. Another consideration for workers considering the move is the low cost of migration. The authorities of the two countries agreed that migrant workers from the Lao PDR must pay $226 for a 2-year visa and work permit, but the fee includes a medical examination and health insurance.

The Lao PDR must improve competitiveness, community, and connectivity to converge incomes and living standards. High rates of out-migration hamper the Lao PDR's ability to benefit from its demographic dividend. It may also deepen inequality between GMS countries. Addressing the challenge will require innovative solutions, including a comprehensive program that addresses macroeconomic vulnerabilities and challenges in the labor market. It is important for the government to support local industrial development through regulatory reform that improves the business environment. Greater engagement among the government, employers, schools, and other training providers is needed to ensure that the education and skilling system is geared toward making local industry more competitive. Also important is to continue to promote convergence in living standards in the GMS, particularly through fostering knowledge spillover to promote local industry development throughout the subregion.